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FINANCE for the POOR

Emergency Loans: The Other Side Of Microcredit

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Microcredit is known for its valuable contribution to poverty alleviation and to a lesser extent job creation. Small loans for income generation allow poor households to instigate new economic activities or to expand existing microenterprises.[2] Yet enterprise loans only fulfill half of credit's poverty alleviating potential. When considering the needs of the poorest households, equally if not more important are emergency loans that allow them to smooth income and consumption.

The movement out of poverty fostered by microenterprise credit is slow and patchy. Poor people do not emerge from poverty just because they have received one or two income-generating loans; even a steady stream of enterprise loans may be insufficient. Any livelihood improvements that do occur are precarious; they can easily be reversed by shocks to the household that affect income, expenses, or both. Sustainable poverty alleviation typically requires, among other things, long-term access to a range of financial services—savings as well as credit, and perhaps remittances and insurance as well.

While increasing attention has been given to savings, insurance and remittances, surprisingly little literature has emerged about the other side of microcredit: emergency loans. This article attempts to correct this imbalance by first clarifying what is meant by an emergency loan and then explaining why many microfinance institutions (MFIs) do not offer such services.

(continued on page 2)

[1] This article reflects the author's personal opinions and does not represent an official position of the International Labour Organization. The author gratefully appreciates valuable comments and suggestions from Patrick Daru, Nimal Fernando, Guillemette Jaffrin, Judith Sanderse, and Peter van Rooij.

[2] While in some contexts "income-generating" and "microenterprise" loans are quite distinct, in this paper the terms are used interchangeably.

Emergency Loans: The Other Side of Microcredit

(continued from page 1)

Next the article makes a case for why MFIs should offer emergency loans. Finally, it describes different options for designing emergency loans and assesses their strengths and weaknesses.

Features of an Emergency Loan

The term emergency loan conjures up images of typhoons, earthquakes, and post-war reconstruction. That is not the intended meaning of the term in this article. While MFIs should certainly have contingency plans for dealing with disasters (Brown and Nagarajan, 2000), this article focuses on something more mundane: loans that allow low-income persons to cope with idiosyncratic risks such as illness, a death in the family, and other urgent, unexpected needs for cash. The primary purpose of these loans is to help households smooth a temporary cash flow constraint so that consumption becomes less dependent on income during the short term.

In that context, the main characteristics of an emergency loan, as defined in this article, are: a small amount of money that is immediately available and repaid in a relatively short period of time. In practice, such an "emergency" loan has the same characteristics as a consumer loan and could in fact be used for a variety of purposes. Or, to put it another way, loans that are not specifically intended for emergencies could be used to address them. Consequently, this paper considers any loan that facilitates immediate access to small amounts of money as an emergency loan, which includes salary-backed loans, pawn loans, and loans from the internal account of a village bank or self-help group.

Why MFIs Do Not Offer Emergency Loans

Most MFIs consider loans that are not meant for income generation purposes as "non-productive." MFIs are often reticent from offering these loans for a variety of reasons. The most common concern is the perceived credit risk associated with loans that do not generate income. This logic assumes that households cannot afford to repay a loan unless it is used to stimulate additional revenue. This belief is unfounded. Many poor households borrow instead from friends, families, and moneylenders—perhaps under irrational loan terms—and presumably find some way to repay. Besides, in practice many clients do not fully use their income-generating loans for productive purposes anyway, and the adverse effect on portfolio quality is probably marginal to nil.[3]

Some MFIs recognize that clients need emergency loans, but the organization's delivery systems are not geared toward providing them. To offer quick, hassle-free loans, credit decisions need to be made close to the clients, which requires a delivery mechanism in the field with loan approval authority. Some MFIs, particularly those operating in rural areas, find it difficult and expensive to use their existing delivery channels to provide such a service. Typically emergency loans would also be for individuals, which may not synchronize well with all group methodologies. Furthermore, to control credit risk, some MFIs do not allow clients to have more than one loan outstanding at a time.

In some countries, MFIs are actively discouraged from non-productive lending by policymakers who do not appreciate the critical importance of emergency loans. There is a widely held perception that consumer loans are bad, that they contribute to over indebtedness by encouraging people to spend beyond their means. Since consumer and emergency loans share some characteristics, the latter is victimized by the bias against the former. While over indebtedness is a legitimate challenge, it should not prevent people from accessing an essential poverty-alleviating financial service.

Why MFIs Should Offer Emergency Loans

The partiality for productive loans, and prejudice against consumption loans, suggests that some policymakers and practitioners are only seeing half of the microcredit picture. Indeed, the provision of emergency loans could be extremely beneficial for client and MFI alike.

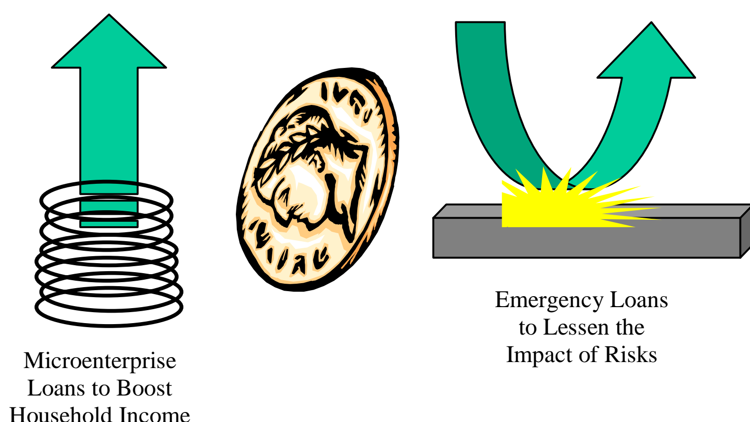
From the client's perspective, the vulnerability of low-income households is not eliminated by access to income-generating loans. While a microenterprise loan may help poor households reduce their vulnerability by boosting income and assets, it is not an effective means to manage risks. Loan sizes, terms, and eligibility requirements (e.g., group guarantees, weeks of pre-loan meetings, compulsory savings) make most microenterprise loans unsuitable to address a household's short-term need for cash.

Poor households that have access to microenterprise loans remain vulnerable to numerous economic stresses. Some risks contribute to unexpected increases in household expenses, such as rebuilding a damaged house, paying for burial costs, or travelling to visit a sick relative. Other risks, such as temporary unemployment, death of livestock, or theft of productive assets, reduce a household's expected income. Some risks increase expenses *and* reduce income, such as the illness or death of a breadwinner. Emergency loans are, therefore, valuable complements to microenterprise loans, providing safety nets to low-income households to resist the downward pressures of economic stresses, as depicted in Figure 1.

Although the logic to offer emergency loans emerges from a compelling

[3] Some MFIs argue that repayment problems are caused by clients using loans for non-productive purposes. An alternative explanation is that such infrequent problems probably stem from a mismatch between the product and the use, and from the fact that credit decisions are based on repayment history rather than repayment capacity.

Figure 1. Microenterprise Credit and Emergency Loans: Two Sides of the Same Coin



case for reducing vulnerability, the argument is strengthened by the fact that borrowers can use an emergency loan for other reasons, including for productive purposes. Quick access to small amounts of money can enable a microentrepreneur to seize a market opportunity. The fact that the loan could be used for a variety of purposes might be viewed as a criticism by some policymakers, particularly those that want to discourage consumerism. But why is it bad if someone uses this loan to purchase a radio or stove, as long as they are able to repay it? Even if one could make that argument, which is dubious, is it justifiable to prevent people from accessing emergency loans because one wants to thwart consumer spending?

From the MFI's perspective, varied loan products can enlarge an organization's market. Not all poor persons are self-employed or want income-generating loans, so the provision of non-productive loans can broaden an MFI's impact by allowing it to serve low-income communities as a whole. If the organization does serve a broader market, then an emergency loan product also diversifies an MFI's credit risk. The cross-selling of emergency loans to existing clients allows the organization to increase the outstanding balance per client which—assuming that risks are sufficiently controlled—increases per client profitability since there are no additional acquisition costs. By quickly helping clients during times of need, the MFI is also likely to strengthen customer loyalty.

Although many MFIs are interested in developing savings and insurance services to help clients manage household and business risks—and so they should be—an emergency loan is probably an easier service for many organizations to develop, particularly for nongovernment organizations (NGOs). Microcredit NGOs are typically prohibited from mobilizing deposits and should only offer insurance as an agent for an insurance company. The provision of emergency loans, however, is in line with the core competency of microcredit NGOs—i.e., delivering microenterprise loans—and therefore will not require fundamental changes to their systems or human resource needs.

MFIs that develop means for delivering emergency loans may learn a thing or two about flexibility that could positively affect the design of their other microcredit products. If such improvements were to occur, it would raise a pertinent question: is it necessary to have multiple loan products or would it be better to have one flexible loan that could be used for many purposes? MFIs definitely need to be wary of product proliferation, which could create significant confusion for clients and staff alike. There are some important advantages, however, in maintaining some degree of product specialization, such as:

- *Marketing* may be more effective if the organization is communicating a specific message. Assuming that the message is responding to an identified client need or preference, advertising for a housing or emergency loan, for example, may resonate better than the promoting a multipurpose loan.

MEET OUR MICROFINANCE PROJECT STAFF

Betty Wilkinson

Ms. Wilkinson is Microfinance Specialist in the Governance, Finance and Trade Division of the East and Central Asia Department of the Asian Development Bank (ADB). Before joining ADB in August 2003, she was the Associate Director at the Center for Institutional Reform and the Informal Sector at the University of Maryland. Her recent work has focused on microfinance legislation, regulation, and supervision. Ms. Wilkinson has worked with a wide range of microfinance institutions including credit unions, Grameen Bank-style institutions, village banks, and a variety of other models of microfinance service provision at national, regional and institutional levels. Her country experience in microfinance includes South Africa, Angola, Bangladesh, Bosnia, People's Republic of China, Ghana, Malawi, Nepal, Papua New Guinea, Tajikistan, Tanzania, and Zambia.

At ADB, her responsibilities include administration of the recently approved Microfinance Systems Development Program and Project for Tajikistan, and work on rural credit and microfinance issues in the People's Republic of China.

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- *Staff training* may be quite different for loans that are used for different purposes. More experienced and expensive loan officers are needed for complicated products, like housing or small business loans, whereas less expensive staff could manage basic products.
- *Credit risk controls* and eligibility requirements vary significantly between different loan purposes. An emergency loan might require very little paperwork or assessment, whereas a business plan and financial statements may be needed for a small business loan.
- *Monitoring* the link between loan purpose and portfolio quality is a critical step in an MFI's risk management system. Monitoring will help improve the entire portfolio, although it is more likely that certain subsets will experience delinquency problems. Product specialization allows MFIs to identify such problems and make the necessary adjustments.

When Credit is the Right Choice

Along with savings and insurance, emergency loans are one of three types of risk-managing financial services that enable low-income households to cope with economic stresses. Generally, savings is the most versatile and least expensive. Ideally savings is the preferred option for expected expenses, such as school fees and religious ceremonies. Insurance is most relevant for larger expenses stemming from risks that are less likely to occur. For the risk-pooling function of insurance to work, the policyholder should prevent a risk event from occuring (Brown and Churchill, 1999). An emergency loan may be appropriate to cover unexpected economic stresses in the event that someone has not built up sufficient savings reserves or prefers not to deplete them, and for risks that are not covered or not sufficiently covered by insurance.

Irregular income makes it difficult to save, but it also makes savings all the more important to have as a buffer for the weeks or months with little or no income. Emergency loans might help fill this gap, reducing the need for distress-selling—i.e., the selling of assets to access quick cash, usually at a below-market rate—by allowing people to borrow against future earnings. Credit is only a possible solution, however, if prospective borrowers can convince lenders that they will have (i) future earnings to repay the loan, and (ii) sufficient security to guarantee the loan.

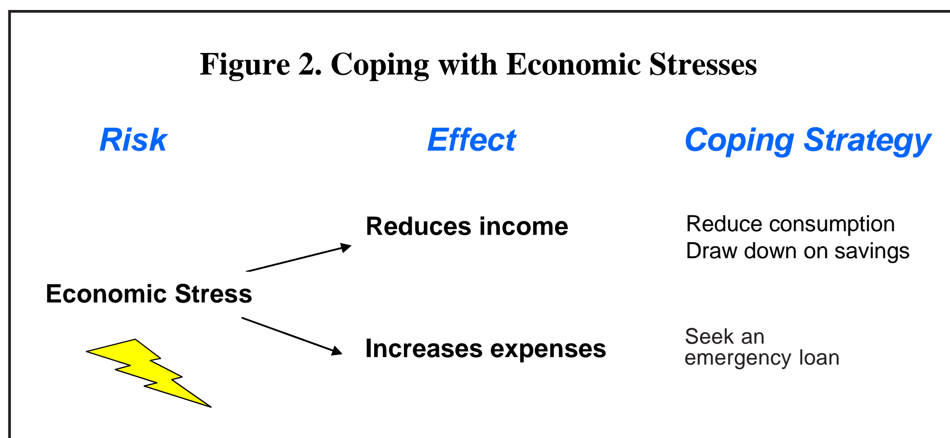

Figure 2. Coping with Economic Stresses

The choice between relying on savings versus borrowing should depend partly on whether the economic stress decreases income or increases expenses in the medium term, as shown in Figure 2. Drought, for example, decreases income in the same way that a microentrepreneur would experience poor market conditions. In both cases, the preferred response would be to reduce consumption and/or draw down on savings. Credit is an undesirable coping strategy in this situation because the expected reduction of income in the coming months means that it will be difficult to service the loan. An MFI should avoid extending a loan in these circumstances; it could worsen the borrower's situation since inevitable late payments would damage the household's ability to borrow in the future.

When deciding between savings and credit, it is also important to consider whether the economic stress has created a temporary or a more permanent and structural cash flow problem. A long-term economic stress, such as the death of a breadwinner, cannot easily be smoothed over by a small, short-term loan.

Alternatively, if the shock generates an expense but does not adversely affect one's gross income, then an emergency loan could be a reasonable solution. For example, the death of a child would create an unexpected funeral expense without affecting income (unless the child was working). So rather than draw down on savings, which should be reserved for a time when a peril suppresses household income, an emergency loan for the additional expense might be appropriate.

A slight twist to this logic emerges when accessing savings means cashing in on productive assets. If someone's primary savings strategy is to reinvest in his or her microenterprise, then drawing down on savings would decrease revenue generation. In this situation, a loan might serve the household better than de-capitalizing the business.

Designing Emergency Loans

Three issues of particular concern in designing emergency loans— interest rate, credit risk, and delivery methods—are discussed below.

Interest Rate

Interest rate is the most straightforward of the three. There may be an inclination for organizations to offer emergency loans at a lower interest rate than other credit products since clients who request these loans are experiencing a financial hardship. That inclination should be avoided because discounted loans will stimulate a huge demand for ersatz emergencies. In fact, it is possible to argue that the risks and transaction costs associated with small, short-term loans could justify a higher interest rate than an income-generating loan. In addition, if the MFI strongly prefers that loans are indeed used for real emergencies rather than for con-

Box 1: Preferred Services at Calpiá

Financiera Calpiá, a microfinance institution in El Salvador, has a customer rating system that enables its best customers to access preferred services. The rating system combines quantitative and qualitative indicators on a scale from 1 to 5. The quantitative measure is based on the average number of days late per repayment; customers who average less than 3 days late receive an excellent rating (1) and those between 3 and 5 receive a good rating (2). Using the same scale, the loan officer also gives the customer a rating based on his or her cooperativeness. Consequently, if a customer missed a payment because of a good reason like a death in the family, the loan officer rating can make sure that she is not unduly penalized.

Customers who receive a 1 or 2 rating for several standard microenterprise loans become eligible to access a second-tier of preferred loan products, including seasonal loans and automatic credit. **Seasonal loans** are short-term working capital loans intended for periods of peak business demand, although they could also be used for emergency purposes. These loans are accessed concurrently with microenterprise loans for customers whose previous loan was repaid with a 1 rating and who have never exceeded a 2 on any loan. Calpiá's **automatic** credit is similar to a line of credit, except that each time customers draw down on their credit limit, they sign a separate loan contract. To access automatic credit, the customer must have repaid three standard loans with a 1 rating or maintained a 1 rating for 12 months. Once they are eligible for automatic credit, customers receive a "Preferred Customer" identification card and the loan officer conducts a detailed analysis of the business to set the credit limit. The interest rate on the automatic credit is also lower than on the standard loan product to reward those customers and encourage their loyalty.

Source: Churchill, 1999.

sumer purposes, then a higher interest rate might contribute to that objective.

Controlling Credit Risk

An emergency loan product needs to respond to crises without over indebting clients, and without worsening the MFI's portfolio quality by throwing good money after bad. There are several different approaches that an MFI might take toward controlling the credit risk of an emergency loan.

The most common method for MFIs is to rely on the client's **credit history** as a collateral substitute. Borrowers who have repaid several loans without a late payment are eligible for a parallel loan—no questions asked, as long as the loan amount is below a pre-approved threshold. For example, as described in Box 1, Financiera Calpia in El Salvador has a customer rating system based on repayment history. Clients with the best ratings are eligible for small, short-term loans that can be accessed concurrently with microenterprise loans. Along the same lines, in the Philippines CARD Bank's multipurpose loan is a parallel loan available to existing clients with a good track record.

The logic of this credit risk control is that the service is so valuable that clients would strive to maintain their good standing and retain eligibility for future emergency (and microenterprise) loans. The most important advantage of the credit history approach, besides the ease of administration, is that it creates a strong customer loyalty incentive: it rewards the MFI's best clients by providing them with access to a preferred service.

In using this approach, MFIs need to be careful to use credit history to determine eligibility, but not the loan amount. Automatically determining loan sizes based on the amounts repaid to date runs the risk of over indebting households. The loan amount should be based on repayment capacity. Since a capacity assessment could delay the delivery of an emergency loan, some organizations conduct periodic assessments to determine how much clients would be eligible for, and then allow them to draw down amounts below that ceiling when and if they need it.

The primary downside of the credit history approach is that the MFI has a limited scope in helping poor households to manage risks. Because only persons with outstanding microenterprise loans are eligible, credit history "collateral" is not particularly effective in serving the low-income community at large. This disadvantage could be fixed in a competitive market if one's credit history was not institutionally specific, i.e., if there was a well-functioning credit bureau that allowed customers to shop around their track record.

Guarantors or cosigners can also be used to control credit risk. Since vulnerable persons already rely heavily on the economic support of family and friends, a guarantor arrangement might be a way of institutionalizing family or social obligations without upsetting the cash flow of the assistance provider. Guarantors could be provided within the context of a borrower group, whereby the group approves and guarantees a member's loan, or it could be organized on an individual basis outside the group system. An individual arrangement would make it possible for MFIs to address the broader community's need for emergency loans instead of just serving existing borrowers.

The main challenge to controlling credit risk through guarantors is whether the legal system can easily and cost effectively enforce the contract. Another limitation is whether people who need emergency loans can find cosigners who would meet the MFI's criteria. In addition, the process of verifying that indeed the guarantor met the eligibility criteria might make it difficult to make credit decisions in a timely manner, unless prospective guarantors were pre-approved before a loan is actually needed.

Another way of limiting the credit risk of small loans is by lending to persons who earn a regular salary. **Salary-backed loans** are the preferred approach for most consumer lending, and are prevalent in many countries, most notably in South Africa. In some settings, it is common to find at least one person in a poor household who receives a regular, if small, paycheck. Risks and transaction costs can be further reduced if the employer makes repayments directly to the lender. For MFIs, salary-backed loans can be a fairly low-risk, high-return business that meets the demand for quick cash, but only for a portion of the market. Salary-backed loans are not an effective option in helping the poor manage risks in countries where the vast majority of people work in the informal economy.

Credit risk for an emergency loan can also be managed through non-traditional collateral, such as a **pawn lending** arrangement with jewelry or

other small, valuable items (see Box 2 and Fernando, 2003). For this type of security to work, the MFI needs the expertise to assess the value of the collateral and a safe means of storing it until the loan is repaid. A pawn-lending facility also requires a retail outlet or a method for selling unclaimed items. If these conditions could be met, then a pawn loan could be extremely versatile. Assuming that a pawnbroker is locally available, transaction costs are quite minimal for lender and borrower alike. Possible disadvantages exist: do low-income households have assets to pawn, and is pawning a culturally acceptable means of accessing funds?

Box 2: Pawn Loans at the Cajas Municipales in Peru

The Cajas Municipales (CMACs) offer pawn loans for emergency purposes to provide a low cost alternative to the moneylenders. The average size of the pawn loans in 1995 was between $70 and $110. Of the CMACs' three basic loan products—the other two being microenterprise and salary-backed loans—the pawn loans carry the highest interest rates, between 6–7% per month, and typically serve the poorest clients.

When a new *caja* is established, this is the first credit product it offers. The CMACs begin with pawn lending because it is low risk—which is important since client savings are used to finance loans from the start of operations—and because it is simple, requires minimal assessment, and is inexpensive to administer. Only gold jewellery (and sometimes silver) is accepted as collateral.

Credit delivery is instantaneous. Clients can receive 50–60% of the value of the pawned object. The loan term ranges from 2 weeks to 3 months, and repayments are weekly. Once repaid, loans can be renewed up to three times consecutively using the same pawned item. The efficiency of delivery and the low risk make this an attractive product despite the small loan sizes and the high repayment frequency.

Source: Churchill, 1999.

Delivery Methods

Perhaps even more challenging than controlling credit risk is designing an effective delivery method. By definition, loans need to be made immediately available at a location that is close to the client. Perhaps the ideal arrangement from the borrowers' perspective would be daily door-to-door service (e.g., SafeSave in Bangladesh[4]) or a large branch network that would ensure that facilities were close at hand. Unfortunately these overhead costs can only be justified where there is a market concentration, in cities and towns. To reach out to villages and rural areas, one possibility is through part-time branches that are only staffed a couple of days a week—but what happens if someone desperately needs money during an off day? Another possibility is a system of mobile outlets that spend an hour in 6 or 8 villages a day, although they may represent a security risk.

To overcome the delivery challenge, the original design of the village banking methodology called for groups to maintain an internal account, which would be capitalized through mandatory savings. Village banks could then lend out that money as they saw fit. These funds were often used for emergency loans, to help members who had urgent needs for small amounts of money. A similar arrangement occurs in the self-help group methodology common in India. Some of the limitations of this approach to providing emergency loans include the following.

- Does the group have the capacity to manage the funds while preventing fraud and misuse by group leaders?
- Are the funds kept in a safe yet convenient location that allows quick access?
- Is the internal account sufficiently capitalized to address the needs of several group members at once?
- Can the village bank effectively serve members as well to provide emergency loans to the broader community?

Another approach worth exploring is to establish mutually beneficial partnerships with local shopkeepers. They already have financial transactions with poor people and may already be acting as moneylenders. Shopkeepers may be experiencing some difficulties in getting repaid and they may not have sufficient cash to keep up with demand. An MFI, on the other hand, wants to help low-income persons better manage their irregular cash flows, but doing so creates credit risks and transaction costs. If they work together, the MFI might be able to develop systems to improve the shopkeepers' lending efforts, such as pricing, screening, and monitoring, which would also improve the shopkeeper's business by reducing loan losses and increasing sales. Shopkeepers would effectively work as agents for the MFI. The MFI would provide loan capital, training, documentation, and assistance in delinquency management, but the two partners would share the risk. This arrangement might be a boon to the MFI as well because the shopkeepers' familiarity with their customers could reduce information asymmetries, and their proximity to the clients would improve customer value and minimize transaction costs, all without hardly any additional overhead expenses.

Conclusion

Low-income households need quick access to small amounts of money to help them smooth income and expenses. If available, these loans could be as productive as income-generating loans since emergency loans help poor households to avoid selling off productive assets and falling further into poverty. Instead of discouraging such services, policymakers and practitioners should be promoting them, encouraging innovation to overcome the design and delivery challenges. These challenges are indeed significant, particularly controlling credit risks and

[4] SafeSave, a small MFI working in Dhaka's slums, offers unconventional products that are much more flexible than typical microfinance services. SafeSave's clients—men, women, and children—open individual accounts. They are visited everyday in their home or workplace. All transactions—including deposits, withdrawals, loan disbursements, and repayments—are done during that daily visit so the client does not have to visit a branch office or attend meetings. For more details, see Consultative Group to Assist the Poor, September 2000.

developing cost-effective delivery methods. But perhaps the most important challenge is to overcome the unfortunate prejudice against the provision of consumption loans to the poor.

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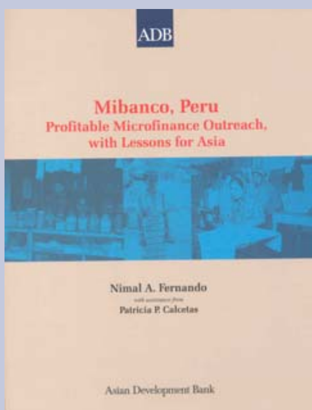

NEW ADB PUBLICATION ON MICROFINANCE

MiBanco, Peru: Profitable Microfinance Outreach, with Lessons for Asia. July 2003. Asian Development Bank: Manila. Hard copy: $10 (inclusive of shipping charges).

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NEWS HIGHLIGHTS

ADB Assists Tajikistan to Develop Microfinance Services

The Asian Development Bank (ADB) in June 2003 approved a package of assistance totaling $8.64 million equivalent to develop the microfinance sector in Tajikistan where the incidence of poverty is about 80% of the population. The package consists of a policy loan and investment loan—each for $4 million— and a technical assistance grant for $640,000.

The policy loan aims to create a supportive legal, regulatory, and supervisory environment for a strong and commercially viable microfinance sector. The investment loan will expand the outreach and sustainability of the country's microfinance institutions by transforming the current unregulated credit programs into licensed and regulated financial institutions. The technical assistance will complement the loans by strengthening supervision of the National Bank of Tajikistan and helping the new microfinance institutions to provide services efficiently and cost-effectively.

ADB Approves a Rural Finance Technical Assistance for Lao PDR

The Asian Development Bank (ADB) approved in July 2003 a $150,000 technical assistance grant to assist the Government of the Lao People's Democratic Republic in preparing a rural and microfinance development project suitable for ADB financing. The ensuing project will address outreach and efficiency issues of rural finance and microfinance services.

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